

Gary Shilling – Economic Forecast and Current Market Opportunities

By Robert Huebscher
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Gary Shilling is President of A. Gary Shilling & Company, the economic consulting and investment advisory firm he founded in 1978. Dr. Shilling is well-known for his forecasting record, having correctly predicted major economic events over the past several decades. Beginning in 2002, he warned his clients that the housing market "has taken on self-feeding, bubble dimensions that will sooner or later collapse," and continued to sound this warning through 2007, when his predictions came true. Dr. Shilling publishes a monthly newsletter, *Insight*, which is available from his [web site](#) or by calling 888-346-

7444. He is the author of several books, the most recent of which, *Deflation*, is available from the link above.

You've been forecasting deflation for some time, and the March CPI numbers validated these forecasts – the first deflationary month since 1955. Can you summarize the major forces in the economy that will continue to keep the CPI numbers in negative territory?

In the short term - for the duration of this recession, which will be at least another year - four very deflationary forces are at play.

First is the ongoing weakness in commodity prices, which takes time to work its way through the system. Crude oil prices are translated quickly to pump prices, but price increases in petrochemicals - which are used, for example, to create plastic parts that go into consumer electronics - take time before their impact is apparent in finished goods. We are getting hit by the collapse of commodity prices, not just from crude oil, although that is the most conspicuous.

Second are excess inventories, which are the mortal enemy of price increases. Manufacturers and retailers must cut prices to get rid of inventories. Right now, merchandisers are cutting prices on spring goods before they are out of their boxes and on the racks. They over-ordered and didn't anticipate demand would fall off a cliff.

The most interesting phenomenon, which we are now seeing for the first time since the 1930s, is wage cuts and shorter hours. In the post-World War II period, the only way employers could cut costs was to lay people off. Under high inflation, employers used another method of controlling labor costs, which was to



freeze pay or raise pay less than the rate of inflation. Now, however, there is no inflation and we are back to the 1930s, when deflation reigned. To lower costs, you must get rid of people or cut hours. About 6% of employers have cut wages or hours in the last year, and another 10% plan to do so. This is less than the number of employers that have had layoffs, which in the 20% area, but it is growing and it is highly deflationary.

The fourth and final deflationary force is excess capacity in the economy. The Commerce Department has an interesting measure, which shows the excess capacity versus demand across the economy. An interesting and powerful relationship is apparent, which shows that excess capacity reduces the CPI with a six-month lag.

For the duration of this year, deflation is the odds-on bet.

Our fiscal and monetary policies are aimed at creating inflation, through further stimulus packages, expanded money supply, or debt monetization. Many say the government will continue on this path until it creates inflation. Why do you believe the government will be unsuccessful?

Your question implies that the government is trying to recreate inflation, and I don't think they are. Paul Volcker and Federal Reserve Vice Chairman Donald Kohn have been debating this issue. Kohn said the Fed is targeting 2% inflation, and Volcker objected, saying that the Fed is "telling people in a generation they're going to be losing half their purchasing power." Volcker was saying you either want inflation or you don't, but the Fed is saying it would rather risk a little bit of inflation. Our government has not achieved a clear consensus on whether it should create inflation.

Deflation becomes self-perpetuating. Consumers see prices decline and delay purchases, which forces retailers and manufacturers to cut back production and labor costs, which drives prices further down. This is the reverse of inflationary expectations.

As far as policy is concerned, the government is trying to resolve the financial crisis and is dealing with an unfolding list of problems as it tries to rekindle economic growth. So far, these efforts have not been very effective. Despite the stimulus, the economy is not growing, and public sector efforts are being offset by the private sector.

Some believe the economy will take off, with consumers regaining confidence and resuming spending, excess liquidity triggering increased lending, and all this will fuel inflation. I don't think this will happen, and I expect much lower growth in the economy. My estimates are GDP growth of 2% annually over the next



decade, as compared to 3.6% during the big salad days of economic boom from 1982-2000.

What are your reasons for this economic decline?

I see five factors inhibiting economic growth.

First is the de-leveraging of the consumer sector, which was on a leveraging tear for three decades. This was obviously manifested in the housing boom, but it also caused the saving rate to run down from 12% in early '80s to 0% as of recently. Consumers relied on savings and home equity to finance their children's education. When stocks fell apart in the tech bubble collapse, housing took over. That era is over and consumers' borrowing power is gone. Stocks collapsed a second time. There have been four stock market declines of 40% or more since 1900 – and two were in the last 10 years. The decline in the saving rate added 0.5% to GDP growth - and that is over. Consumers have maxed out their credit cards. Post-war babies have not saved, and they need to save. Their kids have left home and, if they're like me, they don't have as many smashed-up cars to replace. I am looking at increased savings of 1% per year for the next 12 years, which will work through the economy with a multiplier effect that will knock GDP down by 1% per year..

Like the consumer sector, the financial sector is de-leveraging, after having been on a leveraging binge for three decades. A lot of that leveraging was financial fluff, but it did finance important goods and services. Growth in Eastern Europe and the Baltic region was financed by Western banks. Banks are going back to spread lending, which we can see now, for example, in the recent announcements by Bank of America. With skill, luck, hard work and unlimited free government money, they can't fail. Their balance sheets are still terrible, though. We don't know how much bad paper they have and we can't figure it out. Apparently, the banks don't know either, and were making calculations until the last minute before releasing their numbers. Going back to spread lending will have a big negative effect on economic growth, but is hard to quantify.

Third, we are at the end of the commodities boom. Big commodity producers were spending at a high level, as were smaller countries like Zambia, Peru and Chile, who produce copper. During the boom, buyers lost while producers won, and now the reverse is true. But the buyers are the big industrial countries, so the countries suffering now are the smaller ones. Oil is a very minor part of our GDP, but for Saudi Arabia it is everything.

Increased government involvement has decreased economic efficiency. Banks are wards of the state. They are not interested in taking risk, just in preserving their empires. Government intervention stifles initiatives, and it never quite



works. Wall Street will figure their way around regulations, and Sarbanes Oxley is the prime example.

The final factor is protectionism, which is growing rapidly. Protectionism started in the financial sector. Officially, the recession started in December 2007, but I date it to early in that year. The “subprime slime” began when HSBC took a \$1.7 billion write-down in February, which was the first phase of the meltdown. The second phase began in June 2007, when the two Bear Stearns hedge funds collapsed. After that, nobody trusted anyone. Protectionism began to show up first in the financial area. In October 2008, Ireland guaranteed the deposits of six major banks. The rest of European Union said Ireland was gaining an unfair advantage, but other countries promptly followed suit. The UK went one better. With Gordon Brown under pressure from Northern Rock’s collapse, not only did the UK guarantee deposits but bank loans as well. After first planning to use the TARP to buy toxic assets, Henry Paulson said he would use it to inject money into banks, spurring a competitive race to provide the best protection for financial institutions. On a global level there was competitive protectionism in the financial arena. Then began phase three - the retrenchment of the US consumer – which started in Q4 of 2008. Protectionism heated up in the goods and service side of the economy. We saw this in the “buy American” provisions in the Obama stimulus plan. We banned trucks from Mexico, and they retaliated by imposing tariffs. These measures will slow growth and, if its gets serious, it will cut off growth.

What if you are wrong and the economy starts growing – will we still face deflation?

Even if I am wrong, and the economy revives more rapidly, there are a couple of offsets that will prevent liquidity from turning into inflation.

Central bankers are unequivocally opposed to inflation. When they take their jobs, it is as if they are injected with anti-inflation DNA. I have no doubt - and Ben Bernanke has said this - that if things take off, the Fed will yank back liquidity hand-over-fist.

Private sector weakness is offsetting everything going on in the public sector. Derivatives were a source of liquidity - for example, to finance housing - but de-leveraging is cutting the outstanding amount rapidly. Credit default swaps are half the size of what they were a year ago. Even adjusting for double-counting, the amount of derivatives outstanding is huge compared to total G-7 money supply. So the liquidity that’s disappearing with derivative destruction swamps any the central banks can or will create.



In late January you [wrote](#) that it is “way too early to get back into U.S. stocks.” Is that still your recommendation? What signs are you watching to determine when US equities will be attractive?

Stocks anticipate the economy. It's normally five to six months before the end of a recession that they hit their low point. If we are right that the economy will bottom a year from now, then stocks will bottom late this year. Since stocks are a leading indicator, the question is what leads this leading indicator.

Three things must happen to clear the path for stocks to recover.

First, we must eliminate excess housing inventories. Even with weak housing starts, we still have two million extra houses (over and above normal levels) left over from the building boom that started in the late 1990s. Depressed prices mean destruction of home equity and reduced consumer purchasing power. It encourages walk-aways, which results in foreclosures, and perpetuates a self-feeding destructive cycle.

If nature runs its course, it will take until the end of next year to get down to where home prices will level off. We need another 15% decline (for a 37% total decline) in housing prices. Half of homeowners with mortgages - about 25 out of 50 million people - will be underwater, to the tune of one trillion dollars. This problem must be solved. Richard LeFrak and I wrote an [op-ed piece](#) that appeared in the *Wall Street Journal*, where we argued that we should sell foreclosed houses to foreigners who want permanent residence in this country. Instead, our approach has been to dump these houses on the market at prices that are reduced by 40-50%, which drags down all home prices. Clearly, this is not a good solution.

Second, we must deal with additional financial problems that are surfacing. So far, our problems have been related to residential mortgages, but consumers are treating payments on other kinds of loans – credit cards, auto loans, home equity loans, student loans – as discretionary. Financial responsibility is going out the window. The TALF is supposed to deal with this, and we will see if it really works. As it stands, the Fed can buy only AAA-rated paper, but the problem lies in paper that is not rated AAA.

Commercial real estate (except for hotels) is suffering from overbuilding. We have excess capacity in warehouses, malls, and offices. Sublease space is competing with new space. Hotels are facing declining occupancy. The underlying problem was refinancing that added leverage, and a lot of this debt is coming due and will be difficult to roll over.



Markets still face a problem with junk bonds (which are now at 18% spreads) and leveraged loans. Delinquencies and charge-offs are just getting under way. Holders of these securities have not anticipated the write-offs that will come.

Third, the fiscal stimulus is too small to break the cycle of lack of consumer spending, inventory build-up, production cutbacks, and unemployment. This cycle feeds on itself. The fiscal stimulus funds a lot of Obama's social agenda - with spending on health, education, and the environment - but only about \$200 billion is spent on infrastructure. Putting money into circulation will not do the job. We will need to come back mid-year with a rock-hard asset stimulus to put money into circulation and break cycle of consumer retrenchment.

Another thing is important here – normally, recovery begins with a revival of housing as the Fed cuts interest rates (which can no longer happen) and ends with inventory liquidation (but the collapse in consumer spending will swamp any inventory reductions this time around). In past recessions, consumer spending has not declined at all. The decline now is greater than in any post-war recession, and will swamp any inventory reductions.

We will have a sluggish recovery at best.

What is your target for the S&P?

I am on record with a target of 600 on the downside for the S&P 500, based on my forecast of \$40 in operating earnings and a generous multiple of 15. I made that projection last November when the bottom-up analysts' forecast was \$83 and the top-down forecast was \$62. They are closing in on me. We have another 25% decline to hit the bottom, which I expect in the later part of this year.

A year ago you offered [13 investment strategies](#) for 2008, and in hindsight they were very prescient. Can you discuss some of the strategies you are recommending for 2009?

Every year, in the January issue of our *Insight* publication, we offer our investment strategies. Last year, 13 out of 13 worked well. Probably a lot of luck was involved, but someone in my office calculated the odds of batting 13 out of 13, and it was one out of 8,192, so it is more than just dumb luck. We updated this in January. A number of our ideas from a year ago are pretty well exploited. For example, investors can no longer profit from the collapse in the subprime market or from the decline in Treasury bond yields. Thirty-year Treasury bonds have been one of my favorite asset classes since 1981 when yields were 14.1%. Yields went to 2.6% at the end of last year, and investors in this asset class, which is supposedly only suitable for conservative investors, earned a 42.5%



total return. That is over. Another fully exploited asset class is junk bonds, as charge-offs haven't leaped but spreads have.

Stocks are going down, but I am still bullish on the dollar – it is the best of a bad lot. The dollar will fill its traditional role in a global recession, where people run to it for a safe haven. Looking across the major currencies, there are reasons why they will be weak. The problem with the Euro is its “one size fits all” design in the face of countries with divergent economies. The southern countries (Italy, Spain, and Greece) are weak economically and are issuing debt. That debt will be downgraded and there is a threat they will abandon the Eurozone. The Euro will be driven down to 1.0 from 1.3 against the dollar.

The UK has a huge financial sector that is in trouble. The financial sector accounts for 15% of the UK employment, versus 5% of our workforce. Canada, Australia, and New Zealand are being hit by weak commodity prices, which hurts both the volume and prices of their exports. The dollar against all of those currencies looks interesting.

I am cautiously recommending high-grade municipal and corporate bonds. They have rallied nicely since the beginning of the year, but downgrades – not defaults – are a tricky problem there.

There will be downward pressure on homebuilding and housing-related stocks, consumer discretionary stocks, commodities, and emerging market debt and equity.

What is your personal asset allocation, at an asset class level?

The best way to answer that is to look at how we run our portfolios, which is on the basis of strategies.

We are long the dollar, short stocks, and long Treasury bonds. A lot of these are the same trade. Last year only three asset classes went up: Treasury bonds, gold, and the Yen. Everything else went down. There is so much hot money that it ends up on same side of every trade at the same time. Investors bail out of bad ideas at the same time to preserve capital.

What about gold?

I am agnostic on gold.



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